

Proposed § 1.482–9(e) permits the application of the various profit level indicators provided in existing § 1.482–5(b)(4)(ii) to controlled services transactions. As noted in existing § 1.482–5(b)(4), whether the use of a particular profit level indicator is appropriate depends upon a number of factors, including the extent to which the profit level indicator is likely to produce a reliable measure of the income that the tested party would have earned had it dealt with controlled taxpayers at arm's length. In this regard, caution should be exercised in applying these profit level indicators to controlled services transactions. For example, application of the rate of return on capital employed profit level indicator may produce unreliable results because the reliability of this profit level indicator decreases as operating assets play a lesser role in generating operating profits for both the tested party and the uncontrolled comparable. In addition, reliability under this profit level indicator depends on the extent to which the composition of the tested party's assets is similar to that of the uncontrolled comparable.

With respect to financial ratios, the lack of uniformity regarding the presentation for financial accounting purposes of costs of providing services (as noted in the description of cost of services plus method above) and the limited availability of detailed information regarding the cost accounting practices of uncontrolled parties suggest that the reliability of the profit level indicators that depend on segmentation of such costs may be reduced. Existing § 1.482–5(c)(3) states that the reliability of results derived from the comparable profits method is affected by the quality of the data used to apply this method. Due to the lack of uniformity regarding the presentation for financial accounting purposes of costs of providing services, it may be difficult to determine, for example, whether costs included in costs of goods sold or operating expenses reported by uncontrolled taxpayers are in fact comparable to the corresponding costs incurred by the controlled taxpayer in the relevant business activity. Consequently, an arm's length charge determined by use of the ratio of gross profit to operating expenses as a profit level indicator may not be reliable.

Proposed § 1.482–9(e)(2)(ii) describes a new profit level indicator that may be more reliable in the context of controlled services transactions. The proposed regulations define this profit level indicator as the ratio of operating profits to total services costs (defined in proposed § 1.482–9(j)), or the markup on

total costs (also referred to as the “net cost plus”). This new profit level indicator evaluates operating profits based on a markup on all costs related to the provision of services. This new profit level indicator is more likely to result in a cost base used to determine the controlled taxpayer's comparable operating profit that is comparable to the cost base used by uncontrolled parties to calculate their operating profits in similar business activities.

The proposed regulations state that the degree of consistency in accounting practices between the controlled services transaction and the uncontrolled transaction will affect the reliability of the results under this method. If appropriate adjustments to account for such differences are not possible, the reliability of the results determined under this method will be reduced.

Proposed § 1.482–9(e)(3) provides examples that illustrate various aspects of the application of the comparable profits methods to controlled services transactions.

6. Simplified Cost-Based Method— § 1.482–9(f)

a. Overview. The proposed regulation provides for a new simplified cost-based method for low-margin services, such as routine back-office services. This simplified method is intended by the Treasury Department and the IRS to serve the same purpose as the current regulations relating to the pricing of non-integral services by providing reduced compliance and administrative burdens with respect to the transfer pricing of low-margin services. Such reduced burdens allow both taxpayers and the IRS to direct their resources appropriately to other issues. The Treasury Department and the IRS believe, however, that certain aspects of the rules in the current regulations intended to deal with low-margin services are problematic and therefore should be modified. In particular, the current regulations in some cases have been interpreted or applied to reach inappropriate results from a policy perspective by allowing high-margin controlled services to be priced at cost. Further, the qualitative and subjective tests in the current regulations for determining whether a controlled service may be priced at cost have been difficult to apply and have led to disputes.

Therefore, while the simplified method is intended to maintain reduced compliance and administrative burdens with respect to the pricing of low-margin services, it differs from the current rules regarding the pricing of

low-margin services in significant respects. In particular, the simplified method is based on comparability principles, and the administrative benefits of the simplified method decrease as the margins attributable to the service at issue increase. Thus, the simplified method is more consistent with the arm's length standard and will limit significantly the potential for arbitrariness and controversy that makes the current rules problematic.

b. General Description of Method— § 1.482–9(f)(1). The simplified method allows services that meet certain requirements and conditions to be priced by reference to the markup on total services costs of uncontrolled taxpayers that engage in similar business activities under similar circumstances. The markup on total services costs under the simplified cost-based method corresponds to the profit level indicator of the ratio of operating profit to total services costs, or net cost plus, which is provided for under the comparable profits method for services in proposed § 1.482–9(e). Proposed § 1.482–9(f)(1)(i) provides that if a controlled services transaction that meets the conditions and requirements of proposed § 1.482–9(f) is priced under the simplified method, that method will be considered the best method for purposes of § 1.482–1(c). In effect, the conditions and requirements for the application of the simplified method are a substitute for a traditional best method analysis.

c. Limitation on Allocations by the Commissioner— § 1.482–9(f)(2). The distinguishing feature of the simplified method is a limitation on the ability of the Commissioner to make allocations that he could otherwise make under the general transfer pricing rules. Proposed § 1.482–9(f)(2)(i) provides generally that the Commissioner may make an allocation under the simplified method only if the arm's length markup on total costs, as determined by the Commissioner under the general transfer pricing rules, exceeds the markup charged by the taxpayer by at least a specified number of percentage points. This “applicable number of percentage points” is six if the amount charged by the taxpayer is equal to total costs, and it declines ratably to zero by one percentage point for every increase of two percentage points in the markup on total costs charged by the taxpayer. Thus, for example, if a taxpayer prices controlled services at cost under this method, the Commissioner may make an allocation only if the arm's length markup on total costs is at least 6 percent. As the markup charged by the taxpayer on the controlled services